IT 02-0006-PLR 12/31/2002 APPORTIONMENT – FINANCIAL ORGANIZATIONS

Private Letter Ruling: Rulings on various issues arising in the application of the financial organization apportionment formula.

December 31, 2002

Dear:

This is in response to your letter dated August 14, 2002, in which you request a Private Letter Ruling on behalf of your client, COMPANY1. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to Taxpayer for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that Taxpayer and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

Pursuant to 2 Ill. Admin. Code Sec. 1200.110, our client, COMPANY1., a Delaware Corporation, on behalf of its greater than 80%-owned subsidiary, COMPANY2 and COMPANY2's proposed subsidiary, COMPANY3, which would be an Illinois limited liability company, requests that the Illinois Department of Revenue issue a Private Letter Ruling ("PLR") interpreting the application to COMPANY2 and COMPANY3 of the Illinois income tax and replacement tax laws and the Department's regulations administering the same in the proposed restructuring transaction engaged in by COMPANY2 and COMPANY3.

I. Administrative Matters

1. An original Form IL-2848, Power of Attorney, authorizing the undersigned to represent COMPANY1 is enclosed.

2. This request concerns the application of the Illinois income tax and replacement tax laws.

3. The PLR is not requested with regard to a hypothetical transaction. The PLR is requested with regard to a future transaction that will take place based on the Department's response to this PLR.

4. COMPANY1 and its subsidiaries are currently under audit by the Department for tax years 1997 through 1999.

5. At this time, we are not enclosing any documents pertinent to this request.

6. To the best of the knowledge of employees and representatives of COMPANY1 and its affiliates, and to the best of my knowledge, the Department has not previously ruled on the application of Illinois income tax and replacement tax law to COMPANY1 and its affiliates under the facts as presented, and the issues raised herein have not previously been formally submitted to the Department by COMPANY1 or a member of its affiliated group.

7. COMPANY1 respectfully requests that all business names, addresses, business locations, country names, and representative names be deleted from the PLR prior to public dissemination.

II. Statement of Authority

There are no direct cases or Illinois Private Letter Rulings addressing the specific facts described herein. Where pertinent to the issue discussed, we have referenced the existing authorities and rulings.

For simplicity and clarity, the *Issues Presented* for the Department's consideration and ruling are set forth following the Statement of Facts.

III. Statement of Facts

COMPANY1 is a diversified service company. COMPANY1 conducts a substantial portion of its operations through its greater then 80%-owned subsidiary, COMPANY2. COMPANY1 and COMPANY2 are headquartered in Illinois.

COMPANY2 lends substantial funds to its subsidiary companies and affiliated partnerships. The amount of the loan to a subsidiary is determined by the borrowing subsidiary's annual budget needs including certain capital projects initiated by COMPANY2. Once the subsidiary's spending needs for the year is determined, COMPANY2 lends the subsidiary an amount sufficient to cover any shortfalls in cash as they arise. The interest terms of the COMPANY2 loan to the subsidiary are tied to the market prime rate with some rates fixed at date of borrowing but most floating at variable rates. The duration of the notes varies, although two-year notes are the most common.

At any point in time, COMPANY2 may hold notes receivable from over one hundred subsidiary companies and partnerships.

Relevant legal entities

The structure and transactions we are considering will impact COMPANY2 and its proposed subsidiary, COMPANY3.

The initial formation transaction

COMPANY2 will form COMPANY3 as an Illinois single member limited liability company (SMLLC). COMPANY2 will contribute cash in exchange for its membership interest, which is expected to qualify as tax-free transaction under Internal Revenue Code Section 351.

For federal income tax purposes, COMPANY3 will elect to be classified as an association taxable as a corporation and will also be treated as a corporation for Illinois income tax purposes under Section 1501(a)(4) of the IITA. COMPANY3 will be commercially domiciled in Illinois.

COMPANY2 will identify its outstanding notes receivable at a fixed date. The borrowing entities' asset additions and payments for intercompany services, primarily payments to an affiliate for services performed by its employees, will be identified to support that the funds were used to purchase tangible personal property or services. It is anticipated that these two sources will support that the majority, if not all, of the borrowed funds were used for the purchase of tangible personal property or services.

COMPANY3 will purchase the identified notes receivable from COMPANY2, in exchange for a promissory note, at an arm's length amount. The amount purchased will be at a fixed date to be determined. COMPANY3's purchase of the notes receivable will be at fair market value, which could be below their face amount. The fair market value of the notes will be based on the prevailing market rate of interest at the time of the sale, the due date of the notes, the creditworthiness of the borrowers, and the costs associated with the collection process. Under the terms of the sale, the obligors of the purchased notes receivable will become obligors of COMPANY3**.**

The post-formation operations

After COMPANY3 purchases the notes receivable from COMPANY2, COMPANY3 will collect interest and principal payments with respect to both the purchased notes receivable and new loans. COMPANY3 will establish a bank account at a non-Illinois affiliate of a bank that is domiciled in Illinois. COMPANY3's borrowers will wire transfer their interest and principal payments to the COMPANY3 bank account located outside of Illinois. The funds, representing interest and principal, will be subsequently transferred from COMPANY3's non-Illinois bank account to COMPANY3's bank account in Illinois. COMPANY3 will lend future cash needs to the operating companies, based on the excess of the operating companies budgeted expenditures over available cash. The terms of the new loans will be tied to prime with generally a one to two-year term. At the end of each year, documentation of the asset purchases, and intercompany service fees paid (primarily to an affiliate for services performed by its employees) will be reviewed to verify that the loan proceeds were for the express purpose of purchasing tangible personal property or services.

The Illinois Unitary Business Groups

COMPANY3 will qualify as an Illinois sales finance company under IITA Section 1501(a)(8), and will use the Illinois financial organization apportionment provisions of IITA Section 304(c). As such, IITA Section 1501(a)(27) will exclude COMPANY3 from the existing COMPANY1 unitary group which apportions income pursuant to IITA Sections 304(a) and (h). COMPANY3 will therefore file a separate Illinois income and replacement tax return.

IV. Issues Presented / Rulings Requested

A. Under IITA Section 1501(a)(8)

1.. Whether expenses incurred by COMPANY2 subsidiaries to purchase intercompany services, professional services (whether rendered by third parties or employees of an affiliate), rent of tangible personal property, rent of land, and utility services fall within

the meaning of the phrase "purchases of . . . . services," as used in IITA Section 1501(a)(8)(C)(i), such that having more than 50% of gross income from loans to such subsidiaries for the express purpose of funding such purchases would qualify the lender as a SFC.

Ruling: The plain and ordinary meaning of the word "services" is used to apply Section 1501(a)(8). Consequently, the phrase "purchases of services" encompasses intercompany services, payroll expenses, fees for professional services (whether rendered by third parties or employees of an affiliate), rental charges for the use of tangible personal property, and charges for utilities. Rental charges for the use of real property do not fall within the scope of qualifying services or of purchases of tangible personal property. The expense and gross receipts from a sale / purchase of tangible personal property or services between affiliates are often eliminated in the computation of income and apportionment of the unitary business group to which the affiliates belong. However, that elimination for income tax purposes is irrelevant to whether a borrower in a loan made by the SFC used the funds to buy tangible personal property or services. The elimination is made when necessary to avoid distortion of the income and apportionment of the unitary group within which the sale/purchase takes place, a purpose wholly unrelated to determining whether tangible personal property and services were exchanged for valuable consideration funded with proceeds of the loan made by the SFC affiliate.

2. *Whether a loan made to cover the shortfall of cash to fund purchases of tangible personal property and services provided for in a formally prepared, submitted and approved budget is made "for the express purpose of funding" such purchases within the meaning of Section 1501(a)(8)(C)(i).*

Ruling: So long as the borrower represents in writing to the lender during the budgeting process for the current year, that the purpose of the loan is to fund purchases of tangible personal property and services, and the loan is made in good faith upon that representation, the loan will be considered to have been made "for the express purpose" of funding purchases of tangible personal property or services by the borrower within the meaning of Section 1501(a)(8)(C)(i). The documentation evidencing a formal budget tender and approval for the expenditure of budgeted amounts for purchases of tangible personal property or services shall, if presented to the lender as the basis for seeking the loan, be sufficient to evidence that the loan is made for the express purpose of funding such purchases within the meaning of Section 1501(a)(8)(C)(i). It is not necessary that a subsequent purchaser of such loans, if it seeks to attain or maintain its status as a "financial organization" for purposes of Section 1501(a)(8) of the IITA, further verify the purpose for which the loan was sought or to which the proceeds were devoted so long as that purchaser can provide documentation from either the original lender or the borrower to establish the requisite purpose for the loans.

3.. *Whether, for the purpose of computing the SFC's compliance with the more than 50% of gross income test, the SFC loan portfolio:*

   a. *May consist of loans or loan balances that were used for the express purpose of funding purchases of tangible personal property or services as well as from loans or loan balances that were used for other purposes; or,*

b. Must consist only of loans and loan balances that were exclusively used for the express purpose of funding purchases of tangible personal property or services.

Ruling: The more than 50% of gross income test is applied on an aggregate basis and not on a loan-by-loan basis. Consequently, it is not relevant whether an individual loan or balance thereof is used by the borrower for the express purpose of purchasing tangible personal property or services so long as more than 50% of the taxpayer's gross income is derived from loans made by the lender for the express purpose of funding purchases of tangible personal property or services.

4. Whether the "express purpose" requirement for new loans originated by SFC will be fulfilled by the budget approval, funding, and reconciliation process.

Ruling: Yes. While the SFC need not approve the budget, it may rely on the budget submitted and approved as proof that the intended purpose for which the loan is sought is to make some or all of the purchases of tangible personal property and services approved in the budget.

5. Whether for purposes of IITA Section 1501(a)(8) SFC will qualify as an Illinois sales finance company if 100% of its transactions are with affiliated subsidiaries and partnerships.

Ruling: Yes. As long as the transactions engaged in by the subsidiary are characteristic of those engaged in by a sales finance company, as described in Section 1501(a)(8) and section 100.9710 of the IITA regulations, it is irrelevant whether the transactions are between affiliated companies.

B. Under IITA Section 304(c)(1)(C)

1. Whether amounts SFC collects from borrowers in excess of loan purchase price will be characterized as interest income.

Ruling: Yes. The amounts representing the discount from the face value of the loan are, when collected by the purchaser of the loan, considered interest income.

2. Whether, for purposes of IITA Section 304(c)(1)(C) the interest SFC will receive on the loans purchased from COMPANY2 will be interest from "Illinois customers."

Ruling: If the loans are made to a company that is commercially domiciled in Illinois, such company would qualify as an Illinois customer for purposes of IITA Section 304(c)(1)(C). It is the Department's position in prior private letter rulings and in the proposed regulations administering Section 304(c)(1)(C) that when loan balances are purchased, as opposed to assigned or otherwise transferred by means other than purchase, the customer of the loan seller becomes the customer of the loan purchaser for purposes of Section 304(c)(1)(C).

3. Whether, for purposes of Section 304(c)(1)(C) interest payments received by SFC will be considered received outside Illinois.

Ruling: Payments sent by the borrower / customer to an SFC lockbox outside Illinois or directed by the borrower / customer by electronic funds transfer to an SFC bank account outside Illinois are considered received outside of Illinois. This is true even if SFC subsequently transfers the funds to a central bank account in Illinois.

V. Applicable Illinois Law

Citations for and pertinent text of certain authorities are provided as needed herein.

VI. Taxpayer Analysis:

A. Under IITA Section 1501(a)(8)

1. Whether expenses incurred by COMPANY2 subsidiaries to purchase intercompany services, professional services (whether rendered by third parties or employees of an affiliate), rent of tangible personal property, rent of land and utility services fall within the meaning of the phrase "purchases of . . . . services" as used in IITA Section 1501(a)(8)(C)(i) such that having more than 50% of gross income from loans to such subsidiaries for the express purpose of funding such purchases would qualify the lender as a SFC.

An entity primarily in "the business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower" is a sales finance company under the IITA. *35 ILCS Sec. 1501(a)(8)(C)(i).* The IITA provides no definition of "services." The Department's regulation on the meaning of a financial organization, including a sales finance company, also provides no special definition for the term services. In Illinois, when interpreting a statute to acquire the intent of the legislature, " [t]he plain language is controlling unless a different legislative intent is apparent from the purpose and history of the Act." Continental Illinois National Bank and Trust Co. of Chicago et al. v. Department of Revenue, *450 N.E.2d 844 (filed May 31, 1983 , released July 11, 1983) Citing* Bodine Electric Co. v. Allphin , 81 Ill. 2d 502, 410 N.E.2d 828 (1980); Mitchell v. Mahin*), 51 Ill. 2d 452, 283 N.E.2d 465, cert. den. 409 U.S. 982 (1972)*; Thorpe v. Mahin *, 43 Ill. 2d 36, 250 N.E.2d 633 (1969).* There is nothing in Section 1501(a)(8) of the IITA that suggests a legislative intent to give special meaning to the otherwise plain language of that provision, and likewise, there is nothing so suggesting that intent in the purpose and history of the IITA and Section 1501(a)(8) specifically. Consequently, the term "services" when used in Section 1501(a)(8)(C)(i) ought to be accorded the plain and ordinary meaning it has in common usage as that is the meaning that reflects the intent of the General Assembly.

In our discussions preceding this ruling request we explored whether the fact that intercompany sales within a combined return group would be eliminated should impact whether such sales are considered qualifying purchases for purposes of determining the SFC's percentage of gross income from qualifying loans. The sales are between separate legal entities with valuable consideration exchanged in return for tangible personal property or services. Were these not actual sales between legal entities there would be no need for the elimination in a combined return. Moreover, the elimination of intercompany receipts and expenses is not always required, except where necessary to eliminate distortion of the

business activities reflected in the Illinois return. 86 Ill. Admin. Code Sec. 100.3320(f)(5). So, since the elimination for combined return income and apportionment is not an absolute requirement, it is not a suitable criterion to disqualify related party purchases for purposes of determining the SFC status of a taxpayer lending to such a party.

The SFC definition in Section 1501(a)(8)(C)(i) of the IITA has no terms from which one can infer that the income tax profile of any of the parties in the loan or purchase transactions should affect the plain meaning of the statutory language. A classification that disqualifies certain lenders from SFC status for IITA purposes based on whether certain borrowers are required to file a combined return with the affiliates with whom they have engaged in intercompany sales/purchases would seem to contravene the Illinois constitutional mandate of reasonable classification with the goal of achieving uniform taxation among subjects or items of taxation. See, e.g., Searle Pharmaceuticals Inc. v. Department of Revenue, 117 Ill. 2d 454, 512 N.E. 2d 1240 (1987).

The following example illustrates the constitutional issue:

> Company D makes loans to affiliates B (a transportation company) and C (a manufacturing company) to fund their purchase of tangible personal property and services. Affiliates B and C purchase certain services from parent A. Parent A and subsidiary C file an Illinois combined return. Affiliate B is prohibited from joining that return by Section 1501(a)(27) of the IITA because B apportions income pursuant to a different statutory formula than is used by A and C. Company D, to determine it's status as an SFC for IITA purposes, would be able to rely on sales from A to B, which are not eliminated in a combined return, in computing its gross income from loans made for a qualifying purpose under Section 1501(a)(8)(C)(i) of the IITA. However, Company D would not be able to rely on the sales from A to C, which are eliminated in a combined return, even though both purchases by B and C were made with funds borrowed from D and both B and C purchased identical services from A.

There is clearly no rational basis reasonably related to the purpose the legislature sought to further in defining a sales finance company in the IITA that supports a classification of qualifying purchases and loans that is tied to whether the borrower is required by its Illinois mandated filing status to eliminate the purchases funded by the loans.

Consequently, based on a plain reading of the statute as intended by the legislature, we anticipate that the term "services" will include expense items such as intercompany services, professional services, rental of tangible personal property, utilities, and other similar expenditures. In the course of discussions with the Department preceding this ruling request the Department objected to the inclusion of rental of real estate within the scope of the meaning of the term "services" and we understand the Department will so rule.

2. *Whether a loan made specifically to cover the shortfall of cash to fund purchases of tangible personal property and services provided for in a formally prepared, submitted and approved budget is made "for the express purpose of funding" such purchases within the meaning of Section 1501(a)(8)(C)(i).*

COMPANY2 and its borrowers currently budget anticipated cash needs at the beginning of the year and COMPANY2 lends the shortfalls in cash needs as they arise. At the end of the year, the borrowers identify tangible personal property purchases and service expenses that were funded with the loan proceeds. The formal budgeting process is sufficient to expressly identify to the lender the borrower's anticipated use of the borrowed funds. The year-end reconciliation, which is already a necessary component of preparing a budget for the following year, provides supporting documentation for audit purposes that all or a specified portion of the borrowed funds were used for the purchase of tangible personal property or services.

The term "express purpose" as used in *IITA Section 1501(a)(8)(C)(i)* is not defined in the statute or the related regulation *86 Ill. Admin. Code Section 100.9710,* so it ought to be given the plain and ordinary meaning it has in common usage. The statute does not require that the lender verify that the borrower has indeed complied with the express purpose for which the loan was made, so the formal budget process described above satisfies the requirement that the purpose of the loan, purchasing tangible personal property or services, is expressed by the borrower and known to the lender in order to determine the amount of the loan. If the Department finds that the lender had knowledge that the documented purpose for the loan was false, the Department has adequate remedies in its penalty provisions to address that situation. See, i.e., 35 ILCS 735/3-6(a). Absent evidence of such a situation, the documentation provided to the lender by the borrower should suffice to determine the express purpose for which a loan was made.

We would prefer a ruling that focuses on what is known to the lender at the time the loan is made, and believe that is the appropriate focus. However, since Section 1501(a)(8)(C)(i) does not distinguish between affiliated and non-affiliated lenders and borrowers, there are alternatives which, although in our view are more a matter of audit technique, the Department may choose to rule upon. As noted above, the term "express purpose" as used in *IITA Section 1501(a)(8)(C)(i)* is not defined in the statute or related regulation *86 Ill. Admin. Code Section 100.9710*. Similarly, the statute does not set at what stage in the loan process one must determine what the "express purpose" of a loan will be or has become is also not set forth. Alternative methods for establishing the "express purpose" of a loan could be used; for example:

* borrowers may document their purchases of tangible personal property or services and reconcile such amounts to borrowed funds at the end of each tax year without reference to the budget process; or,

* borrowers may provide a year-end attestation to COMPANY3 that all or a specified portion of the borrowed funds were used for the express purposes of funding purchases of tangible personal property or services; or,

* borrowers may document their "nonqualifying expenditures" for such items as stock purchases, operating licenses, software or real estate. Third party interest expense would also be reviewed to identify other sources of cash. The amount of nonqualifying expenditures would be compared to qualified expenditures to verify that the qualifying expenditures were sufficiently greater than nonqualifying expenditures and that borrowed funds were used for qualified expenditures. This simple method should

provide a quick and sufficient means of qualifying a pool of loans without delving into expenditures in transactional detail.

3. Whether for the purpose of computing the SFC's compliance with the more than 50% of gross income test the SFC loan portfolio:

a. May consist of loans or loan balances that were used for the express purpose of funding purchases of tangible personal property or services as well as from loans or loan balances that were used for other purposes; or,

b. Must consist only of loans and loan balances that were exclusively used for the express purpose of funding purchases of tangible personal property or services.

The Department's regulation requires a taxpayer claiming to be a "financial organization" to be "predominantly engaged in the business activities of a financial organization during the year." 86 Ill. Admin. Code Sec. 100.9710(b). For that purpose, an entity that is "engaged in business activities of a financial organization, as well as other activities in the same tax year," is a financial organization only if, in the case of a "sales finance company," more than 50% "of the entity's gross income, averaged over a period of three years . . . is derived from the business activities characteristic of one or more categories of financial organization" defined in the regulation. Id. For purposes of the 50% test, gross income includes "only amounts that are received in the ordinary course of the entity's regular business activities and that are included in net income" under the IITA. Id.

It is clear from the statute and the regulations that the 50% of gross income test is an aggregate test. Thus, Section 1501(a)(8) contemplates that a financial organization may engage in:

* some activities which are either characteristic of one or more entities that qualify for financial organization classification; or,

* some activities that are not characteristic of a financial organization at all but yet do not, on an aggregate basis, affect the predominant character of the activities engaged in and do not imperil the entity's status as a "financial organization."

All that is required is that more than 50% of COMPANY3's gross income be from "characteristic services in subsections (d)(10(A) and (B)" of the Department's regulation. 86 Ill. Admin. Code Sec. 100.9710(d)(10)(C).

All of the COMPANY2 notes receivable created pursuant to the previously described budget approval process will have been made for the express purpose of funding purchases of tangible personal property or services by the borrower. However, we anticipate that a small percentage of the COMPANY2 loans or balances thereof that COMPANY3 will purchase will not yet have been used for qualified purchases. Since COMPANY3 will engage in no activity other than purchasing balances of loans made for the express purpose of purchasing tangible personal property or services, and subsequently of making loans for such an express purposes, COMPANY3 should qualify as a "financial organization" as long as on an aggregate

basis more than 50% of the gross income of COMPANY3 is derived from loans made for the express purpose of funding purchases of tangible personal property or services.

In the initial year of operations, the answer is no different, even though in that year it is possible that more of COMPANY3's gross income may derive from loans it acquired from COMPANY2 rather than loans COMPANY3 originated. After COMPANY3 purchases the notes receivable from COMPANY2, COMPANY3 will be legally entitled to payment from the borrowers under the terms of the sale. As such, COMPANY3 will be in the business of extending credit or "making loans." The Department's current proposed regulation administering the apportionment of income pursuant to Section 304(c) of the IITA, proposed as Section 100.3400, provides that "if a financial organization purchases a customer account receivable from a company, the company's customer thereby becomes a customer of the financial organization." Sec. 100.3400(b)(1)(B)(ii). The regulation does not require that the company selling the account receivable be a financial organization, and deals with the buyer's apportionment of income from such accounts receivable, as a financial organization. When COMPANY3 purchases the loans receivable balances from COMPANY2, the borrowers / customers of COMPANY2 with respect to those loans receivable should, in accord with the Department's proposed regulation, become the customers of COMPANY3.

One of the characteristic services of a sales finance company is "the business of purchasing customer receivables." IITA Sec. 1501(a)(8)(C)(i); 86 Ill. Admin. Code Sec. 100.9710(d)(10)(A). For purposes of Section 100.9710(d)(10)(A), " a' customer receivable' means . . . a loan or balance under a loan, made by the lender for the express purpose of funding purchases of tangible personal property or services by the borrower." 86 Ill. Admin. Code Sec. 100.9710(d)(10)(A)(iv). Consequently, upon the purchase of the loans from COMPANY2, COMPANY3 should qualify as a sales finance company for purposes of Section 1501(a)(8)(C)(i)

Thus, we expect COMPANY3 to qualify as a sales finance company in its initial year; even though its purchased loan portfolio may include loans, a percentage of which were not used for a qualified purpose.

4. *Whether "express purpose" requirement for new loans originated by COMPANY3 will be fulfilled by the budget approval, funding, and reconciliation process.*

We rely on the analysis set forth above for issue number 2 with respect to loans acquired by COMPANY3 from COMPANY2. The fact that COMPANY3 will make loans upon the approval of the budgeted expenditures by COMPANY2 is sufficient to establish that COMPANY3 knows for what express purpose the loan will be made. It is not necessary that COMPANY3 also be the entity that approves the budgeted expenditures.

5. *Whether for purposes of IITA Section 1501(a)(8)* COMPANY3 *will qualify as an Illinois sales finance company if 100% of its transactions are with affiliated subsidiaries and partnerships.*

COMPANY3 will likely extend financing exclusively to affiliated companies. IITA Section 1501(a)(8)(D) specifically provides that "[a] taxpayer that is a 'financial organization' that engages in any transaction with an affiliate shall be a 'financial organization' for all purposes of

this Act." There is no restriction in *IITA Section 1501(a)(8)(C)(i)* or *86 Ill. Admin. Code Section 100.9710* regarding the relationship with the borrower when an entity is primarily making loans for the express purpose of funding purchases of tangible personal property or services by the borrower.

Therefore, COMPANY3 may qualify as an Illinois sales finance company whether or not it lends funds exclusively to affiliates.

B. Under IITA Section 304(c)(1)(C)

1. Whether amounts COMPANY3 collects from borrowers in excess of loan purchase price will be interest income.

COMPANY3 will acquire the notes receivable from COMPANY2, and the rights to receive payment on the notes. COMPANY3's purchase price for the notes will be determined by the market rate of interest at the time of purchase, the expected time and amount of payment on the notes and the creditworthiness of the borrowers. The United States Supreme Court has defined "interest" to mean "compensation for the use or forbearance of money." Deputy v. duPont, 308 US 488, 498 (1940). The Department has expressly adopted that concept of interest in its proposed regulation administering Section 304(c) of the IITA. Proposed Reg. Sec. 100.3400(b)(6). The Department's proposed regulation will, if adopted, provide that "any amount in excess of the purchase price received in payment of an obligation purchased at an arms'-length discount shall be rebuttably presumed to be interest. Proposed Reg. Sec. 100.3400(b)(6)(B). The amounts COMPANY3 will receive in excess of the amounts it will pay for the notes receivable will be compensation received entirely for the use of money and will reflect the factors normally taken into account in determining the amount of interest payable on an advance of funds. Therefore, amounts COMPANY3 receives in excess of purchase price will be classified as interest income.

2. Whether, for purposes of IITA Section 304(c)(1)(C) the interest COMPANY3 will receive on the loans purchased from COMPANY2 will be interest from "Illinois customers."

COMPANY3 will purchase some notes receivable from COMPANY2 with Illinois-domiciled companies as the obligors. Under the terms of the sale, the obligors of the purchased notes receivables will become obligors of COMPANY3. COMPANY3 is also expected to make new loans to Illinois domiciled companies.

The term "Illinois customer" in IITA Section 304(c)(1)(C) is not defined. The Department's proposed regulation to administer Section 304(c) provides that "Illinois customer" means, "a customer other than an individual, trust or estate whose commercial domicile is in Illinois." Proposed Reg. Sec. 100.3400(b)(5)(B). The proposed regulation also provides that unless the financial organization has "actual knowledge that the . . . commercial domicile of a customer is other than the state in which the customer's billing address is located, the customer shall be deemed to be an Illinois customer if the billing address of the customer, as shown in the records of the financial organization relating to the interest income being sources, is located in Illinois and shall be deemed not to be an Illinois customer if that billing address is located outside Illinois." Proposed Reg. Sec. 100.3400(b)(5). Because certain obligors are

expected to be corporations and partnerships domiciled in Illinois, we expect them to qualify as Illinois customers.

3. Whether, for purposes of Section 304(c)(1)(C) interest payments received by COMPANY3 will be considered received outside Illinois

COMPANY3's borrowers will wire transfer their interest and loan payments to an COMPANY3 bank account located at a non-Illinois affiliate of a bank that is domiciled in Illinois. The funds will be subsequently transferred from COMPANY3's non-Illinois bank account to a central bank account in Illinois.

The term "received in this State" in IITA Section 304(c)(1)(C) is undefined in the IITA. The Department's proposed regulation administering Section 304(c)(1)(C) provides that "interest received from an Illinois customer . . . [is] 'received in this state' if the payment comes within the control of the financial organization or of an agent or other fiduciary of the financial organization at a location within the State of Illinois." Proposed Reg. Sec. 100.3400(c)(3)(B). An example in the proposed regulation concludes as follows:

> ii) Example 4: An electronic transfer of funds is received by a financial organization at the location of the bank carrying the account of the financial organization into which the funds are deposited. In the case of a bank with branches in both Illinois and Missouri, whose Federal Reserve Bank account is maintained at the Federal Reserve Bank of St. Louis, an electronic transfer via the Federal Reserve is received by the bank in St. Louis, the location of its account. In the case of a financial organization receiving an electronic transfer via the Federal Reserve through that bank, the payment is received at the branch of the bank in which the financial organization's account is maintained because the payment is not within the financial organization's control until it is deposited into its account by the bank. The deposit of funds into the account of the bank at the Federal Reserve Bank does not place the funds within the control of the financial organization because the bank, merely by participating in the electronic transfer, is not acting as collection agent for the financial organization.

Proposed Reg. Sec. 100.3400(c)(3)(B)(ii). Thus, if the customer electronically transfers the funds to the bank account established at a non-Illinois affiliate of a bank that is domiciled in Illinois the funds will not be considered received in Illinois even if the funds are subsequently transferred to a central bank account in Illinois.

Request for Ruling

We respectfully request rulings as suggested and set forth in the Issues Presented / Rulings Requested section of this PLR request.

Ruling by Department

A. Under IITA Section 1501(a)(8)

1. Whether expenses incurred by COMPANY2 *subsidiaries to purchase intercompany services, professional services (whether rendered by third parties or employees of an affiliate), rent of tangible personal property, rent of land and utility services fall within the meaning of the phrase "purchases of . . . . services" as used in IITA Section 1501(a)(8)(C)(i) such that having more than 50% of gross income from loans to such subsidiaries for the express purpose of funding such purchases would qualify the lender as a SFC.*

IITA § 1501(a)(8) defines a "financial organization" and a "sales finance company" as follows:

(A) The term "financial organization" means any bank, bank holding company, trustcompany, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, *sales finance company*, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a "person" will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.), except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956. (Emphasis added.)

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(C) For purposes of subparagraph (A) of the paragraph, the term "sales finance company" has the meaning provided in the following item (i) or (ii):

(i) A person primarily engaged in one or more of the following businesses:
the business of purchasing customer receivables, the business of making loans upon the security of customer receivables, *business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower*, ... (Emphasis added.)

The definition of a sales finance company contains a "primarily" test describing the activities in which a sales finance company may be engaged. According to 86 Ill.Admin.Code 100.9710(d)(10)(C), a sales finance company "satisfies the primary test ... if more than 50% of its gross income is from its characteristic services."

The first issue becomes whether COMPANY3 qualifies as a sales finance company (hereinafter "SFC") as a result of its prospective "business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower." The answer to this first issue lies in whether purchases of intercompany services, professional services (whether rendered by third parties or employees of an affiliate), rent of tangible personal property, rent of land, and utility services are considered to be "purchases of tangible personal property or service." If yes, the second issue becomes whether these purchases generate more than 50% of COMPANY3's gross income.

Purchases of intercompany services, professional services (whether rendered by third parties or employees of an affiliate) and utility services qualify as "purchases of tangible personal property or

service" for purposes IITA § 1501(a)(8)(C)(i). The purchases of "rent of tangible personal property" and "rent of land" do not qualify as "purchases of tangible personal property or service." According to Black's Law Dictionary, *to purchase* is "[t]o **own** by paying or by promising to pay an agreed price which is enforceable at law" whereas *to rent* is "the compensation or fee paid, usually periodically, for the **use** of any rental property, land, buildings, equipment, etc." Sixth Edition (1990) (emphasis added). Furthermore, "land" is not characterized as tangible personal property. Personal property is defined as "all property other than real estate". Id. As such, rent of land cannot be classified as "tangible personal property".

Your letter states that COMPANY2 lends substantial funds to its subsidiary companies and affiliated partnerships, and that such notes are most commonly of two-year duration. COMPANY2 may hold notes receivable from over one hundred subsidiary companies and partnerships at any one point in time. The borrowing entities will have two sources to support that the majority of the borrowed funds will be used for the purchase of tangible personal property or services: the asset additions and payments for intercompany services.

Furthermore, you state that COMPANY2 will form COMPANY3 as an Illinois single member limited liability company by contributing cash in exchange for its membership interest. Once established, COMPANY3 will purchase the notes receivable from COMPANY2 in an arm's length transaction which will include terms that the obligors of the purchased notes receivable will become obligors of COMPANY3. COMPANY3 will then collect interest and principal payments with respect to both the purchased notes receivable and the new loans.

The fact that COMPANY3 will purchase notes receivable from COMPANY2 will not disqualify COMPANY3 from becoming a SFC. "[T]he business of *making loans* for the express purpose of funding purchases of tangible personal property or services by the borrower" is only one characteristic business activity of a SFC listed in IITA § 1501(a)(8)(C)(i). A SFC may also be in "the business of purchasing customer receivables." IITA § 1501(a)(8)(C)(i). Regardless of whether COMPANY3 makes new loans or purchases notes receivable from COMPANY2, COMPANY3 will meet the SFC definition as provided in the IITA if more than 50% of its gross income is derived from such SFC business activities.

It is not clear from your letter what percentage of gross income comes from "rent of tangible personal property" and "rent of land" as opposed to purchases of intercompany services, professional services and utility services. If the business of making loans for the purpose of purchasing intercompany services, professional services and utility services alone generate more than 50% of COMPANY3's gross income, then COMPANY3 will qualify as a sales finance company.

2. *Whether a loan made specifically to cover the shortfall of cash to fund purchases of tangible personal property and services provided for in a formally prepared, submitted and approved budget is made "for the express purpose of funding" such purchases within the meaning of Section 1501(a)(8)(C)(i).*

The phrase "for the express purpose of funding" as mentioned in IITA § 1501(a)(8)(C)(i) is not defined in the IITA or in the Department's regulations. Your letter states that

COMPANY2 and its borrowers currently budget anticipated cash needs at the beginning of the year and COMPANY2 lends the shortfalls in cash needs as they arise. At the end of the year, the borrowers identify tangible personal property purchases and service expenses that were funded with the loan proceeds. The formal budgeting process is sufficient to expressly identify to the lender the borrower's anticipated use of the borrowed funds. The year-end reconciliation, which is already a necessary component of preparing a budget for the following year, provides supporting documentation for audit purposes that all or a specified portion of the borrowed funds were used for the purchase of tangible personal property or services.

For the above circumstances, written documentation from the borrower to the lender of an approved formal budget for the expenditure of budgeted amounts for purchases of tangible personal property and services shall meet the requirements of a loan made "for the express purpose of funding" such purchases. The lender must have sufficient documentation that the loan is made "for the express purpose of funding" purchases of tangible personal property and services at the time the loan is made. Such documentation shall be retained by the lender in accordance with IITA § 501.

3. *Whether for the purpose of computing the SFC's compliance with the more than 50% of gross income test the SFC loan portfolio:*

a. May consist of loans or loan balances that were used for the express purpose of funding purchases of tangible personal property or services as well as from loans or loan balances that were used for other purposes; or,

b. Must consist only of loans and loan balances that were exclusively used for the express purpose of funding purchases of tangible personal property or services.

According to 86 Ill.Admin.Code 100.9710(d)(10(A)(iv), a "customer receivable" includes

iv) A loan, or balance under a loan, made by a lender for the express purpose of funding purchases of tangible personal property or services by a borrower.

Under this provision, a loan made to fund purchases of tangible personal property and services and to fund other purchases would generate income from the characteristic services of a sales finance company on the balance of the loan made to fund purchases of tangible personal property and services. For example, if a loan is made to fund the purchase of $25,000 in tangible personal property and of $75,000 in real property, 25% of the interest from that loan would be from services characteristic of a sales finance company.

4. Whether "express purpose" requirement for new loans originated by COMPANY3 will be fulfilled by the budget approval, funding, and reconciliation process.

Your letter indicates that COMPANY2 anticipates two sources that will support that the majority, if not all, of the borrowed funds were used for the purchase of tangible personal property or services: the borrowing entities' asset additions and payments for intercompany services. COMPANY3 shall similarly collect supportive documentation that the majority of the borrowed funds were used for the purchase of tangible personal property or services. The borrower should provide COMPANY3 approved budget information indicating the prospective use of the funds borrowed.

According to your letter, the "terms of the new loans will be tied to prime with generally a one to two – year term. At the end of each year, documentation of the asset purchases, and intercompany service fees paid (primarily to an affiliate for services performed by its employees) will be reviewed to verify that the loan proceeds were for the express purpose of purchasing tangible personal property or services." This verification process is sufficient.

5. Whether for purposes of IITA Section 1501(a)(8) COMPANY3 will qualify as an Illinois sales finance company if 100% of its transactions are with affiliated subsidiaries and partnerships.

IITA § 1501(a)(8)(D) states the following: "[a] taxpayer that is a 'financial organization' that engages in any transaction with an affiliate shall be a 'financial organization' for all purposes of this Act." It is clear that the statute not only contemplates transactions between affiliates but also specifically approves transactions between affiliates. If all other requirements of a sales finance company are met, COMPANY3 will continue to qualify as a sales finance company even if 100% of its transactions are with affiliated subsidiaries and partnerships.

B. Under IITA Section 304(c)(1)(C)

1. Whether amounts COMPANY3 collects from borrowers in excess of loan purchase price will be interest income.

Both the statute and the regulations address interest income. IITA § 304(c) states as follows:

(b) Financial Organizations.

(1) In general. Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of the amounts referred to in subparagraphs (A) through (E) following, but excluding the adjusted income of an international banking facility as determined in paragraph (2):

…

(C) Dividends, and interest from Illinois customers, which are received within this State;

(D) Interest charged to customers at places of business maintained within this State for carrying debit balances of margin accounts without deduction of any costs incurred in carrying such accounts; …

86 Ill.Admin.Code 100.3400(b)(6) addresses interest income as follows:

6) Interest. "Interest" means "compensation for the use or forbearance of money". See Deputy v. du Pont, 308 U.S. 488, 498 (1940).

A) Interest does not include late payment penalties that are in addition to interest expressly charged on any past-due balance or that are computed without regard to the amount of the past-due balance or the length of time a payment is late.

B) Interest includes the amortization of any discount at which an obligation is purchased and is net of the amortization of any premium at which an obligation is purchased. Any amount in excess of the purchase price received in payment of an obligation purchased at an arm's length discount shall be rebuttably presumed to be interest.

C) Interest includes any amount received upon the sale, exchange or other disposition of an obligation to the extent that such amount represents the accrual of interest on the unpaid balance of the obligation since the most recent payment made on that obligation.

Based on the above authorities, amounts COMPANY3 collects from borrowers in excess of loan purchase price will be interest income, except to the extent of amounts received as late-payment penalties.

2. Whether, for purposes of IITA Section 304(c)(1)(C) the interest COMPANY3 will receive on the loans purchased from COMPANY2 will be interest from "Illinois customers."

The Department regulations define an "Illinois customer" in 86 Ill.Admin.Code 100.3400(b)(5):

5) Illinois customer. "Illinois customer" means:

A) A customer who is an Illinois resident individual, trust or estate; or

B) A customer other than an individual, trust or estate whose commercial domicile is in Illinois.

Unless a financial organization has actual knowledge that the residence or commercial domicile of a customer during a taxable year is in a state other than the state in which the customer's billing address is located, the customer shall be deemed to be an Illinois customer if the billing address of the customer, as shown in the records of the financial organization relating to the interest income being sourced, is located in Illinois and shall be deemed not to be an Illinois customer if that billing address is located outside Illinois.

Your letter states that "certain obligors are expected to be corporations and partnerships domiciled in Illinois". According to the above regulation, corporations and partnerships that are domiciled in Illinois are considered to be "Illinois customers." Interest received from such corporations and partnerships will be considered interest from "Illinois customers". The fact that interest is being paid to COMPANY3 as a result of a purchase of notes receivable from COMPANY2 does not change the corporation or partnership status as an Illinois customer.

3. Whether, for purposes of Section 304(c)(1)(C) interest payments received by COMPANY3 will be considered received outside Illinois.

The applicable guidelines in determining whether interest payments are sourced to Illinois can be found in 86 Ill.Admin.Code § 100.3400(c)(3):

> 3) Dividends and interest from Illinois customers, which are received within this State. (IITA Section 304(c)(1)(C))
>
> A) Scope. This subsection (c)(3) applies to all dividends included in business income of the financial organization and to all interest (other than interest on margin accounts, which is sourced under the provisions in subsection (b)(4) of this Section) received by the financial organization.
>
> B) Application. Interest is never sourced to Illinois under this subsection (c)(3) unless it is received from an Illinois customer. Interest from an Illinois customer or dividends are "received in this State" if the payment comes within the control of the financial organization or of an agent or other fiduciary of the financial organization at a location within the State of Illinois. If payment of an item of interest income that has been accrued and included in base income for a tax year is not received prior to the date the return for that tax year is filed, the financial organization shall treat the payment as received at the location to which the borrower is directed to send the payment or, if no single location is specified, at the location at which the financial organization reasonably expects to receive the interest. The following examples illustrate the principles for determining when a payment comes within the control of a financial organization:
>
> …
>
> ii) Example 4: An electronic transfer of funds is received by a financial organization at the location of the bank carrying the account of the financial organization into which the funds are deposited. In the case of a bank with branches in both Illinois and Missouri, whose Federal Reserve Bank account is maintained at the Federal Reserve Bank of St.Louis, an electronic transfer via the Federal Reserve is received by the bank in St. Louis, the location of its account. In the case of a financial organization receiving an electronic transfer via the Federal Reserve through that bank, the payment is received at the branch of the bank in which the financial organization's account is maintained because the payment is not within the financial organization's control until deposited into its account by its bank. The deposit of funds into the account of the bank at the Federal Reserve Bank does not place the funds within the control of the financial organization because the bank, merely by participating in the electronic transfer, is not acting as collection agent for the financial organization.

Your letter states as follows:

COMPANY3's borrowers will wire transfer their interest and loan payments to an COMPANY3 bank account located at a non-Illinois affiliate of a bank that is domiciled in Illinois. The funds

will be subsequently transferred from COMPANY3's non-Illinois bank account to a central bank account in Illinois.

In analyzing the facts you have provided with the above regulation, COMPANY3 will gain control of payments made by borrowers when the payment is deposited into the COMPANY3 account located "at a non-Illinois affiliate of a bank that is domiciled in Illinois". If this "non-Illinois affiliate" is located outside of Illinois so that the account where the wire transfers are deposited is outside Illinois, payments are not "received in this State" and will not be sourced to Illinois. However, if the account is located at a bank branch located within Illinois, payments are "received in this State" for purposes of 304(c)(1)(C).

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very truly yours,

Heidi Scott
Associate Counsel – Income Tax